

Franchise Tax Board**ANALYSIS OF ORIGINAL BILL**

Author: Yee Analyst: David Scott Bill Number: SB 364
Related Bills: See Legislative History Telephone: 845-5806 Introduced Date: February 15, 2011
Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Business Tax Incentive Reporting Information and Recapture

SUMMARY

This bill would disallow certain business tax incentives that reduce tax if the taxpayer fails to achieve specified employment requirements.

RECOMMENDATION AND SUPPORTING ARGUMENTS

No position.

PURPOSE OF THE BILL

According to the author's staff, the purpose of this bill is to bring needed transparency and accountability to tax breaks given to taxpayers under the Personal Income Tax Law (PITL) and the Corporation Tax Law (CTL).

EFFECTIVE/OPERATIVE DATE

This bill would be effective and operative on January 1, 2012, and specifically operative for business tax incentives enacted on or after January 1, 2012. The calculation of any net decrease in full-time equivalent employees would be determined on or after January 1, 2015. The bill would be specifically operative for taxable years on or after January 1, 2012, for reporting certain employee information.

ANALYSIS**FEDERAL/STATE LAW**

Existing state and federal laws provide various tax incentives (credits, deductions, exemptions, and other tax benefits) designed to provide tax relief for taxpayers who incur certain expenses (e.g., child adoption) or to influence behavior, including business practices and decisions (e.g., research credits or economic development area hiring credits). These tax benefits are designed to provide incentives for taxpayers to perform various actions or activities that they may not otherwise undertake.

Board Position:

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Department Director

Date

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Internal Revenue Code sections 267, 318, and 707 provide rules relating to the current year deductibility of losses, expenses, and interest with respect to transactions between related taxpayers, rules for determining the constructive ownership of stock, and rules governing transactions between partners and partnerships, respectively.

Recapture

Recapture means to “give back or return” any tax benefit received by a taxpayer for a prior taxable year. Generally, when a tax benefit is recaptured, the amount recaptured is added back to the current year’s income or tax, depending on if the benefit was a deduction or a credit. For example, a taxpayer received a tax credit of \$3,000 in year 1 for hiring certain eligible employees. If those employees were not kept for the required amount of time, as stipulated in the rules for getting the credit, then the taxpayer would add the \$3,000 to the current year’s (year 2) tax.

The following are examples of current California credits with recapture provisions:

- Enterprise Zone Hiring Credit – the credit is recaptured if the employee is terminated without reasonable cause within 270 days of hiring.
- Environmental Preservation Credit – small refiners must recapture the credit taken on a facility if the facility is sold within five years.
- Employee Child Care Facility Credit – the employer must recapture the credit if the facility is disposed of or ceases operations within 60 months.
- Low Income Housing Credit – the credit is recaptured if the taxpayer violates a 30-year regulatory agreement. The former Farm Workers Housing Credit was merged into this credit and contained the same recapture provision.

Assignment of Credits

The CTL allows the assignment of certain eligible credits to taxpayers that are members of a combined reporting group. “Assignment” refers to the ability of a taxpayer that is a member of a combined reporting group to elect to transfer certain unused credits to a related corporation, as specified. The election to transfer any credit is irrevocable once made and is required to be made on the taxpayer’s original return for the taxable year in which the assignment is made.

THIS BILL

This bill would require a taxpayer doing business in the state that claims a business tax incentive, under the PITL or the CTL, to annually submit certain information to the Franchise Tax Board (FTB). The following information must be on a timely filed original return in the form and manner as required by forms and instructions prescribed by the FTB:

- The number of full-time, part-time, and temporary employees, as defined, employed by the taxpayer in the state for the current and preceding taxable years.

This bill would provide that for any business tax incentive allowed by an act that takes effect in a taxable year beginning on or after January 1, 2012, if the taxpayer has a disqualifying event occur before the close of the recapture period, the business tax incentive would be subject to recapture.

The bill defines the following terms:

- “Business tax incentive” would mean a credit, deduction, exclusion, exemption, or any other tax benefit provided by the state that is added by an act that takes effect beginning on or after January 1, 2012, and enacted with the purpose of creating new jobs in the state, and allowed to taxpayers engaged in or carrying on any trade, business, profession, vocation or calling, or commercial activity in the state.
- “Disqualifying event” would be defined as a net decrease in the average number of full-time equivalent employees (see the discussion in the calculation of net decrease below), calculated as of the last day of the current taxable year.
- “Recapture period” would mean the first full taxable year beginning after the close of the taxable year in which the business tax incentive reduces the taxpayer’s taxable income (PITL), net income (CTL), net tax (PITL), or tax (CTL), and the four succeeding taxable years.

Calculation of Net Decrease in Full-time Employees

The net decrease in full-time equivalent employees in the state would be determined on and after January 1, 2015, on a full-time equivalent basis as follows:

- The total number of full-time equivalent employees in the state employed in the three preceding taxable years by the taxpayer and by any trade or business acquired by the taxpayer during the current taxable year, divided by three, minus
- The total number of full-time equivalent employees in the state employed in the current taxable year by the taxpayer and by any trade or business acquired during the current taxable year.

Employees in the state who are employed in any trade or business sold by a taxpayer would be excluded in the determination of the net decrease in full-time equivalent employees.

This bill would define “full-time equivalent” to mean either of the following:

- In the case of a full-time employee paid hourly qualified wages, the total number of hours worked for the taxpayer by the employee (not to exceed 2,000 hours per employee) divided by 2,000.
- In the case of a salaried full-time employee, the total number of weeks worked for the taxpayer by the employee divided by 52.

In addition, the bill would provide that all employees of the trades or businesses that are treated as related under either Section 267, 318, or 707 of the Internal Revenue Code would be treated as employed by a single taxpayer.

This bill would provide the following definitions:

- “Full-time employee” would mean an employee who works an average of 35 hours in a week, calculated monthly.
- “Part-time employee” would mean an employee who works less than an average of 35 hours in a week, calculated monthly.
- “Temporary employee” would mean an employee who works less than 120 days per year.

Recapture Provisions

If there is a disqualifying event, the recaptured amount would be added to income or tax in the taxable year the disqualifying event occurs, including the interest amount.

The recapture amount would be computed by multiplying the total amount of the current taxable year’s business tax incentive and prior taxable years’ business tax incentives, excluding the amounts previously recaptured, by a fraction. The numerator of the fraction would be the net decrease in full-time equivalent employees and the denominator would be the cumulative increase in the full-time equivalent employees calculated from the last day of the first taxable year the business tax incentive was claimed on the return to the last day of the taxable year immediately preceding the taxable year of the disqualifying event.

- If the denominator of the fraction equals zero or a negative amount (because there would be no accumulated increase in full-time equivalent employees or there would actually be a decrease in accumulated full-time equivalent employees), 100 percent of the business tax incentive would be subject to recapture.
- If the fraction is greater than one (because the decrease in full-time employees exceeds the accumulated increase in full-time employees), not more than 100 percent of the business tax incentive could be subject to recapture.

The interest amount would be computed using the adjusted annual rate from the due date of the return for each taxable year in which the business tax incentive reduced a taxpayer’s income or tax to the date of the payment of the additional tax.

The amount of recapture computed would first be applied against the applicable business tax incentives that reduced income or tax for the earliest taxable year, and then to the succeeding taxable years. If there would be any remaining recapture amount, the excess would be applied against remaining carryovers of the business tax incentives.

The recapture amount would be in addition to any other recapture amounts imposed under the PITL or the CTL.

Under the PITL, this bill would not apply to a taxpayer with 25 or fewer employees and with net business income of less than \$500,000 for the taxable year. Under the CTL, this bill would not apply to a taxpayer with 25 or fewer employees and with income subject to tax of less than \$500,000 for the taxable year.

Under the PITL, “business income” would mean: (1) income from a trade or business, whether conducted by the taxpayer or a pass-through entity, owned directly or indirectly by the taxpayer (“pass-through entity” would mean a partnership or S corporation); (2) income from rental activity; and (3) income attributable to a farming business.¹

Assigned Business Tax Incentives (CTL Only)

This bill provides the following rules for business tax incentives that could be sold, assigned, or otherwise transferred:

- Any assignment of a business tax incentive that is allowed to be assigned would only be valid if the seller or assignor expressly agrees to provide the buyer or assignee and the FTB, in the form and manner specified by the FTB, any necessary information to calculate whether a disqualifying event has occurred with respect to the seller or assignor.
- If a disqualifying event occurs, the buyer or assignor would be required to include in income or tax the amount of any required recapture.
- The assignment and recapture rules would apply to any business tax incentive that is assigned under the CTL.
- A notice of proposed deficiency assessment attributable to the business tax incentive to which the reporting requirements were not met could be mailed to the buyer or assignee within four years from the date on which the reporting requirements are met by the seller or assignor. The four-year period does not start until all of the information needed to satisfy the reporting requirements is provided.

This bill would not limit the authority of the FTB to audit the information provided by the taxpayer. In addition, this bill would waive review (by the Office of Administrative Law) of any standard, criterion, procedure, determination, rule, notice, or guideline established or issued by the FTB relating to the information required to be submitted by a taxpayer relating to full-time, part-time, and temporary employees.

Penalties

The amount of the understatement of tax for the taxable year that is attributable to the disallowance or recapture of a business tax incentive would be excluded from the calculation of any penalty under the PITL, CTL, and the Administration of Franchise and Income Tax Law.

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation considerations. Department staff is available to work with the author’s office to resolve these and other concerns that may be identified.

¹ This is the same standard, for defining business income, that applied for 2008 and 2009 for the exception to suspension of net operating losses and tax credits. (Chapter 763 (AB 1452) Laws 2008)

1. It is unclear for how many “preceding taxable years” the taxpayer must report to the FTB, on their timely filed original return, the number of full-time, part-time, and temporary employees. The computation for determining the decrease in full-time equivalent employees uses a three-year average using the preceding three years. For ease of implementation, this bill should specify the number of years the taxpayer must report this information to the FTB.
2. It is unclear if the author is trying to match the years in the computation to the years of the recapture period. The current language leaves open the possibility of including more years than the recapture period. The bill defines the recapture period to be the first year after the taxpayer uses the business tax incentive to reduce their taxable income or “net tax” plus the four succeeding years. This is a total of five years. For ease of implementation, this bill should specify that the prior taxable years means the taxable years of the incentive’s recapture period to prevent the possibility recapturing more than the incentives taken during the recapture period.

LEGISLATIVE HISTORY

SBX 6 20 (Yee, 2009/2010) was nearly identical to this bill, except for suggested technical amendments included in this bill. The bill was held in the Senate Rules Committee.

SB 1391 (Yee, 2009/2010) was nearly identical to this bill, except for suggested technical amendments included in this bill. The bill failed to pass out of the Senate Appropriations Committee.

OTHER STATES’ INFORMATION

Review of *Florida, Illinois, Michigan, Minnesota, and New York* laws found no comparable recapture of business tax incentives. *Massachusetts* has a recapture provision for property that was used to generate a credit, if the property is sold or transferred out of state before the end of its useful life. These states were selected due to their similarities to California's economy, business entity types, and tax laws.

FISCAL IMPACT

This bill would not significantly impact the department’s costs.

ECONOMIC IMPACT

Revenue Estimate

This bill would not impact the state’s income tax revenue because provisions of the current tax law regarding business tax incentives are unchanged.

This bill would place constraints on potential future changes to tax law. The effects of this bill would be incorporated into the revenue estimates for future proposals to add business tax incentives; however, uncertainty exists as to what those future proposals would be and, therefore, an estimate of the revenue effects is impractical.

SUPPORT/OPPOSITION

Support: California Labor Federation (co-sponsor)
State Building and Construction Trades Council of California (co-sponsor)
California Tax Reform Association
California Nurses Association

Opposition: California Grocers Association

ARGUMENTS

Pro: According to the author, this bill would promote greater accountability for keeping jobs in California by taxpayers who have received a tax benefit for creating jobs. In addition, this bill would set clear expectations for corporations and guarantee that the state's investment would yield measurable results in the form of job retention and creation.

Con: Some taxpayers may say that the recapture provision of the bill could unjustly penalize a taxpayer for decreasing the number of California jobs when circumstances for the decrease are beyond the taxpayer's control, such as a severe economic downturn.

LEGISLATIVE STAFF CONTACT

David Scott
Legislative Analyst, FTB
(916) 845-5806
david.scott@ftb.ca.gov

Patrice Gau-Johnson
Asst. Legislative Director, FTB
(916) 845-5521
patrice.gau-johnson@ftb.ca.gov